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THE ECONOMIC OUTLOOK

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

APRIL 21, 2004

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JOINT ECONOMIC COMMITTEE

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C O N T E N T S

Opening Statement of Members

Witness

Submissions for the Record

THE ECONOMIC OUTLOOK

WEDNESDAY, APRIL 21, 2004

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC

The Committee met, pursuant to notice, at 10:00 a.m., in room SH-216 of the Hart Senate Office Building, the Honorable Robert F. Bennett, Chairman of the Committee, presiding.

Senators present: Senators Bennett, Sununu, Alexander, Collins and Sarbanes.

Representatives present: Representatives Saxton, Ryan, Dunn, English, Putnam, Paul, Stark and Hill.

Staff present: Donald Marron, Natasha Moore, Chris Frenze, Brian Higginbotham, Colleen J. Healy, Mike Ashton, Lucia Olivera, Zach Jones, Wendell Primus, Chad Stone, Frank Sammartino, and Matthew Solomon.

OPENING STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Senator Bennett. The Committee will come to order.

We meet this morning in fulfillment of one of our statutory requirements, which is to hear from the Chairman of the Federal Reserve on an annual basis.

Because of the interest in Chairman Greenspan's testimony, we expect a large attendance at this particular hearing. And in an effort to accommodate Chairman Greenspan, who has his own schedule, I will lay down the ground rules.

We will have opening statements from the Chairman, the Ranking Member, and the Vice Chairman. We ask other Members not to give an opening statement, but to hold their comments until we go to the question period.

I will recognize people in the order in which they come. And I ask the staff to keep track of that order so that I don't have to write everybody down as they come in.

But we'll observe the early bird rule and say those who come first get to question first, regardless of their seniority on the Committee.

I've asked Vice Chairman Saxton and Ranking Member Stark to hold their opening statements to four minutes, and I intend to set the example and do that myself, so that we can have maximum time for Members in the question period. And we will try to hold each questioner, each Member, to a five-minute period in an effort to give everyone the opportunity to question Chairman Greenspan

and at the same time conclude the hearing in a timely enough manner so that he can meet his other scheduled requirements.

So with that, Mr. Chairman, we're pleased to have you here today. We always appreciate your views on the current economic situation, as well as your broad perspective on economic and fiscal issues facing Congress.

One of the things that has impressed itself upon me since I've been a Member of the Senate is that very few people in public life have any kind of perspective beyond today's headline or this afternoon's deadline.

And you are an outstanding exception to that rule, as you can see things in a perspective that goes across not only quarters and years, but decades. And I think that that kind of perspective is very important to us.

We're grateful that you're willing to come share it with us this morning.

You visit us at a time of good economic news. The economy is growing rapidly and adding new jobs, thanks to well-timed tax relief, an aggressive Fed policy over which you've presided and, most importantly, the amazing resilience of the American economy itself.

I can't help but notice what a difference a year makes. When we were having this hearing a year ago, we talked a great deal about deflation. But today, we meet amid speculation about inflation.

Last week, we learned that consumer prices have been rising faster than expected and commodity prices are much higher than they were a year ago, due to the strengthening world economy and the lower dollar. Higher commodity prices may eventually lead to higher consumer and producer prices. We've already seen that with gasoline. But the real question is whether they signal broader price increases ahead.

In the sometimes topsy-turvy world of economics, the bond market has treated recent gains in employment as bad news, driving bond prices down and interest rates up. Employment growth is, of course, an unmitigated good for the economy, but it does sharpen the question of how long the Fed will be able to maintain the current low interest rates and how and when the Fed may move to a more neutral policy stance. And we, of course, will welcome your insight on this issue.

I'd also like to indicate we'd be interested in your thoughts on the housing market. Housing has been remarkably strong in recent years. It's boosted the recovery, built wealth for millions of American families, and low mortgage interest rates have been key to housing strength. But the concomitant result has been that home prices have been lifted in much of the nation, raising the cost of living for new home buyers, even as it creates a sense of wealth for existing home buyers. We need to understand how rising home prices might contribute to inflation. And looking ahead, we also need to understand how rising interest rates might affect the housing market.

So those are the issues that are on my mind, Mr. Chairman. We welcome you again and look forward to your testimony.

I now yield to the Vice Chairman, Mr. Saxton.

[The prepared statement of Senator Robert F. Bennett appears in the Submissions for the Record on page 31.]

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

Representative Saxton. Thank you, Mr. Chairman. It gives me great pleasure to join with you in welcoming Chairman Greenspan once again before the Joint Economic Committee.

Let me just say that the evidence shows that the U.S. economy has displayed an amazing resilience in recent years and has now emerged from a painful adjustment process. The bursting of the stock market and technology bubbles began in 2000. The subsequent economic slowdown and recession, terrorist attacks, and wars harmed the economy, but did not prevent the current economic expansion, which began in November of 2001.

The economic data released in recent quarters indicate that the U.S. economy continues to grow at a healthy rate. Over the last half of 2003, economic growth adjusted for inflation was 6 percent. This recent pick-up in the economy was expected for some time, but had been delayed by weakness in business investment.

However, the long-awaited rebound in business investment is now underway and has boosted the economy and has led to a more balanced pattern of economic expansion. For example, in the last two quarters of 2003, investment in equipment and software increased at rates in excess of 15 percent. The increases in investment have contributed to a strong recovery in manufacturing activity.

Meanwhile, consumption and housing activity continue to hold up well. Productivity is very strong and inflation is under control. Recent data indicate that payroll employment growth has resumed. Independent economists have noted that tax relief and accommodative monetary policy have made important contributions to the recent strength in the economy.

Finally, the Blue Chip Consensus forecast is that the U.S. economy will grow at an inflation adjustment rate of nearly 5 percent this year. The return to sustained and healthy economic growth is a tribute to the flexibility and resilience of the American people and our free market economy.

Mr. Chairman, thank you, and I'll be delighted to hear from Chairman Greenspan when you are ready.

[The prepared statement of Representative Jim Saxton appears in the Submissions for the Record on page 31.]

Senator Bennett. Very good.

Mr. Stark.

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Thank you, Mr. Chairman. And welcome, Chairman Greenspan.

I know we all have questions, the same questions that are in everyone's mind today—when? Which way? How much?

We're all waiting to see. Chairman Bennett and I will become very wealthy if you'd whisper those things in our ear and give us a heads-up.

But I don't think that will happen for us today.

Consumer prices went up. Some are fearing inflation. The Fed has committed itself to be patient. My concerns still are job growth.

We haven't seen such persistent job losses since the 1930s. And it wasn't much fun in the 1930s. I remember that.

But we should talk about extension of unemployment benefits. I know that you testified a month or so ago that you would support extending unemployment benefits. I think it would help. I think it would help the economy. And it would certainly help 3 million unemployed workers to avoid financial ruin. Our counties and states are less able than ever to provide public assistance to these people who are out of work.

I don't think training is the answer, because I don't know whether you can take an unemployed electrician and train him or her to be a chiropractor. They're out of work because there aren't jobs and not because they are unemployable.

In the House, extending unemployment benefits has become a partisan battle. We passed extensions a couple of times, or asked to pass them. The leadership in the House has dug in and is not doing anything. The President and the Republican-controlled Congress could pass an extension if they wanted to.

So I look forward to your statements today, Mr. Chairman, about what you see, what kind of good news you may see ahead of us for this spring and summer.

Thank you.

Thank you, Mr. Chairman.

[The prepared statement of Representative Pete Stark appears in the Submissions for the Record on page 32.]

Senator Bennett. Thank you.

Chairman Greenspan, we appreciate your being here and look forward to your testimony.

OPENING STATEMENT OF THE HONORABLE ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Chairman Greenspan. Thank you.

Mr. Chairman and Members of the Committee, I'm pleased, as always, to be here to offer my views on the outlook for the U.S. economy.

The American economy appears to have emerged around the middle of last year from an extended stretch of subpar growth and entered a period of more vigorous expansion. After having risen at an annual rate of 2½ percent in the first half of last year, real GDP increased at an annual pace of more than 6 percent in the second half. Aided by tax cuts, low interest rates, and rising wealth, household spending continued to post sizable gains last year. In addition, an upturn in business investment, which followed several years of lackluster performance, and a sharp rise in exports, contributed importantly to the acceleration in real GDP over 2003.

Although real GDP is not likely to continue advancing at the same pace as in the second half of 2003, recent data indicate that growth of activity has remained robust thus far this year. Household spending has continued to move up, and residential home sales and construction remain at elevated levels. In addition, improvement in business activity has become more widespread.

In the industrial sector, nearly two-thirds of the industries that make up the index of industrial production have experienced an increase in output over the past 3 months. More broadly, indicators of business investment point to increases in spending for many types of capital equipment.

And importantly, the latest employment figures suggest that businesses are becoming more willing to add to their workforces, with the result that the labor market now appears to be gradually improving after a protracted period of weakness.

Looking forward, the prospects for sustaining solid economic growth in the period ahead are good. Monetary policy remains quite accommodative, with short-term real interest rates still close to zero. In addition, fiscal policy will likely continue to provide considerable impetus to domestic spending through the end of the year.

Importantly, the caution among business executives that had previously led them to limit their capital expenditures appears to be giving way to a growing confidence in the durability of the expansion. That confidence has, no doubt, been bolstered by favorable borrowing conditions, ongoing improvements in efficiency, and rising profitability, which have put many firms on a more solid financial footing.

Nevertheless, some of the strains that accompanied the difficult business environment of the past several years apparently still linger. Although businesses are replacing obsolescent equipment at an accelerated pace, many managers continue to exhibit an unusual reluctance to anticipate and prepare for future orders by adding to their capital stock. Despite a dramatic increase in cash flow, business fixed and inventory investment, taken together, have risen only moderately. Indeed, internal corporate funds exceeded investment over the course of last year for the first time since 1975.

Similar cautious behavior has also been evident in the hiring decisions of U.S. firms, during the past several years. Rather than seeking profit opportunities in expanding markets, business managers hunkered down and focused on repairing severely depleted profitability, predominantly by cutting costs and restricting their hiring. Firms succeeded in that endeavor largely by taking advantage of the untapped potential for increased efficiencies that had built up during the rapid capital accumulation of the latter part of the 1990s. That process has not yet played out completely. Many firms seem to be continuing to find new ways to exploit the technological opportunities embodied in the substantial investments in high-tech equipment that they had made over the past decade.

When aggregate demand accelerated in the second half of 2003, the pace of job cuts slowed. But because of the newfound improvements in the efficiency of their operations, firms were able to meet increasing demand without adding many new workers.

As the opportunities to enhance efficiency from the capital investments of the late 1990s inevitably become scarcer, productivity growth will doubtless slow from its recent phenomenal pace. And, if demand continues to firm, companies will ultimately find that they have no choice but to increase their workforces if they are to address growing backlogs of orders. In such an environment, the pace of hiring should pick up on a more sustained basis, bringing

with it larger persistent increases in net employment than those prevailing until recently.

Still, the anxiety that many in our workforce feel will not subside quickly. In March of this year, about 85,000 jobless individuals per week exhausted their unemployment insurance benefits—more than double the 35,000 per week in September, 2000. Moreover, the average duration of unemployment increased from 12 weeks in September, 2000, to 20 weeks in March of this year. These developments have led to a notable rise in insecurity among workers.

Most of the recent increases in productivity have been reflected in a sharp rise in the pretax profits of nonfinancial corporations from a very low 7 percent share of that sector's gross value added in the third quarter of 2002 to a high 12 percent share in the fourth quarter of last year. The increase in real hourly compensation was quite modest over the period. The consequence was a marked fall in the ratio of employees compensation to gross nonfinancial corporate income to a very low level by the standards of the past three decades.

If history is any guide, competitive pressures at some point will shift in favor of real hourly compensation at the expense of corporate profits. That shift, coupled with further gains in employment, should cause labor's share of income to begin to rise toward historical norms.

Such a process need not add to inflation pressures. Although labor costs, which compose nearly two-thirds of consolidated costs, no longer seem to be falling at the pace that prevailed in the second half of last year, those costs have yet to post a decisive upturn. And even if they do, the current high level of profit margins suggests that firms may come under competitive pressure to absorb some acceleration of labor costs. Should such an acceleration of costs persist, however, higher price inflation would inevitably follow.

The pace of economic expansion here and abroad is evidently contributing to some price pressures at earlier stages of the production process and in energy markets, and the decline in the dollar's exchange rate has fostered a modest firming of core import prices. More broadly, however, although the recent data suggest that the worrisome trend of disinflation presumably has come to an end, still-significant productivity growth and a sizable margin of underutilized resources, to date, have checked any sustained acceleration of the general price level and should continue to do so for a time. Moreover, the initial effect of a slowing of productivity growth is more likely to be an easing of profit margins than an acceleration of prices.

As I have noted previously, the federal funds rate must rise at some point to prevent pressures on price inflation from eventually emerging. As yet, the protracted period of monetary accommodation has not fostered an environment in which broad-based inflation pressures appear to be building. But the Federal Reserve recognizes that sustained prosperity requires the maintenance of price stability and will act, as necessary, to ensure that outcome.

Thank you very much, Mr. Chairman. I look forward to your questions.

[The prepared statement of Chairman Greenspan appears in the Submissions for the Record on page 32.]

Senator Bennett. Thank you, sir.

Your final comment that the Fed must act at some point to deal with inflation, raises the question of how we should measure inflation.

What are the best indicators of measuring inflation? You've indicated previously that the CPI may be overstating inflation. But a fellow who talked to me yesterday said that many families do not perceive inflation to be low right now, a legitimate question as to whether or not inflation indices correctly incorporate housing prices. I referred to that a little bit in my opening statement.

So could we talk about the CPI and other indicators and could you give us some indication of what you look for when you try to determine whether or not inflation is just over the horizon?

I remember you saying to the Committee some years past, if you wait until you have clear signs of inflation, it's too late, and you ought to see what's over the horizon.

Well, as you look over the horizon, what are you looking for and what indices do you pay attention to?

Chairman Greenspan. First, Mr. Chairman, let me indicate to you that, as you've heard from, I presume, many witnesses, the Consumer Price Index—that is, the regularly published index—despite the fact that it has been improved immensely by the Bureau of Labor Statistics, which has taken out a significant part of the bias, is, nonetheless, still significantly biased, largely because it's a fixed-weight index and doesn't reflect the changing composition of consumer purchases.

And by the nature of its weighting, it inordinately weights the housing sector far more than it should in the context of the overall economy.

As a consequence, we have chosen what we perceive to be a far more general view of consumer prices, which is the monthly index which is published by the Bureau of Economic Analysis of the Department of Commerce for the deflation of personal consumption expenditures.

It uses virtually all of the individual prices that are in the Consumer Price Index. Indeed, that's the basic source of all data.

But it reweights them and estimates various different components in ways which tend to create an index which has been running below the Consumer Price Index.

That means it is less upward-biased than the CPI. But it is still upward-biased.

And indeed, so is the CPI chain index, which also endeavors to pick up implicitly the mix that is changing in the consumer area. And that index is published every month by the BLS and, in my judgment, is a far superior index to the existing one that currently is published.

Now we look at all price indexes and we look at individual prices. And I must say to you——

Senator Bennett. Including commodities?

Chairman Greenspan. Yes, including commodities, and including the broadest index of all, which is the deflator for the gross domestic product, which picks up capital investment, government and

other individual items which are not captured in any of the Consumer Price Indexes.

With respect to the question of housing, that has always been a very difficult issue to handle.

First of all, there is the much broader question as to whether, in fact, you include prices only of goods and services or whether you start to look at asset prices as well, or a futures price.

In short, the debate on what the price environment is has spread beyond the usual notions of single index.

We estimate the housing costs, or I should say, the BLS does, essentially by, one, getting rental costs, obviously for rental dwellings. But it imputes a price to homeownership by effectively using the data that are picked up on rents and re-adjusting them to try to capture what is the implicit foregone rent of homeowners, on the grounds that shifting from being a renter to a homeowner creates costs. They may be higher, they may be lower. But a number of the costs involved in homeownership are not captured in the sense that you're not paying any rent.

And so, that is an adjustment which takes place. There are very significant disputes on the appropriate handling of this issue and we probably will find that there will be revision after revision, as indeed, there has been for a number of years.

Senator Bennett. Thank you.

I'd like to follow up, but I want to set the example of staying within the time limit. We will do the early bird rule.

Mr. Saxton was here next and so we'll go to him, and then we'll go to Ranking Member Stark.

Representative Saxton. Thank you, Mr. Chairman.

Let me follow up on your question. For many years, we have tried to look over the horizon, and you've led a great example for us, particularly with regard to trying to figure out what inflation may be over that horizon.

In recent months, we have waited anxiously for growth to take place in all sectors of the economy. And finally, we appear to be there.

But wouldn't it be prudent to wait for more data before making changes in the current accommodative stance of monetary policy? That is a question which is obviously on the minds of many Americans today and we're anxious and interested in your response.

Chairman Greenspan. Well, obviously, those are issues which the Federal Open Market Committee discusses at great length and we are meeting in a couple of weeks and we will be discussing the issue. And we'll be meeting periodically thereafter.

I can only speak for the Federal Open Market Committee when they tell me I can speak for it.

So I'm not going to suggest to you that I can give you a pattern of what we may or may not do over the next quarters and potentially, years.

But what we do do is endeavor to look over the horizon. And we have numbers of different scenarios which we believe are credible more or less. And as a consequence of that, we have a sense not only of what we might do in the near-term, but where that eventually leads us, because there is no such thing as a monetary policy which is ad hoc or what do you do next?

Unfortunately, on occasion, that has been our history and it does not work for precisely the reasons the Chairman mentioned earlier.

So we try to be forward-looking and to think in terms not only of whether we will move or not move on a particular date, but what does that imply about a whole program of change, if indeed we are changing.

And remember that the fact that we have done nothing with respect to the federal funds rate for almost a year is a program.

In other words, it's not that nothing has happened and that, therefore, we saw no reason to make any changes. It's been an active program, the conclusion of which is that where we were is where we wanted to be.

So it's a process which we're still learning from.

In other words, we're still developing the means by which we formulate policy and it's becoming more programmatic in the sense that it thinks in terms of strategies rather than individual, period-by-period developments.

And that, as you might imagine, is a rather difficult thing to do—engaging 19 people who are members on the FOMC and none of whom are reluctant to say what they believe.

Representative Saxton. Well, thank you very much, Mr. Chairman.

Mr. Chairman, I'll yield to the next questioner and follow your great example.

Senator Bennett. Thank you very much.

Mr. Stark.

Representative Stark. Thank you, Mr. Chairman.

I have three questions, Mr. Chairman. I'll just run through them and you may whack away at them in any manner you see fit.

First, I would like to have your comment as to whether you still believe, as you testified earlier, that it would be sensible policy to extend unemployment benefits.

My next question deals with the recent proposal of FASB—the Financial Accounting Standards Board—requiring recognizing the cost of employee stock options.

Some of my colleagues would like to block that proposal and I wonder whether you have any position on whether we should, in fact, follow the FASB rules, or at least stay out of their turf.

My third question deals with a topic that we're discussing a good bit, and that is whether we should fix our tax code so that it does not encourage U.S. firms to move capital and jobs to foreign tax havens.

And I don't necessarily refer to just outsourcing, which may go on where labor markets are attractive. But whether we should, in fact, add to that by creating a tax incentive that might encourage companies to move.

Those would be my three areas. If you'd have time to deal with them, I'd appreciate it.

Chairman Greenspan. Mr. Stark, I indicated in my prepared remarks that 85,000 a week of the unemployed are losing their unemployment insurance, which is an exceptionally high number.

I'm of the belief that our unemployment insurance system has been crafted and has evolved in a way which seems to me as close to optimum as you can make such a system.

It does not encourage undue unemployment by creating excess benefits, so that people don't seek jobs when they could. And yet, its replacement rate on existing wages is—of course, it's never adequate, but it's at a reasonable level.

We have extended, of course, unemployment insurance on previous occasions when it was fairly clear that large numbers of the unemployed were unemployed through no fault of their own.

And as I indicated a month ago, which you are reporting on, my view is that if we make the extension short, because it's not going to be required very long, I do think it's a good idea and I think it's a good idea largely because of the size of the degree of exhaustions, which is, in a sense, almost a special case.

With respect to stock options, I think it would be a bad mistake for the Congress to impede FASB in this regard.

First of all, this is an accounting question. I've always argued that accounting is for the purpose of determining whether particular strategies of companies are profitable or not profitable. The whole point of accounting is to tell somebody whether a specific strategy is working or not.

The cost of worker input, labor cost, irrespective of the form in which it's paid, is a critical determinant of the production process and the determination of whether or not a strategy is profitable.

In other words, in simple terms, if your output values are greater than your input values, within certain limits, it's a profitable strategy.

If you take one of the significant elements of input of costs and take it off the table—if you don't expense stock options—then you're getting a distorted view as to what the profitability of a particular operation is and you will get a distortion in the allocation of capital.

Now it may very well make individual firms look more profitable than they are, and people don't like to change that. But the point at issue is not whether it is more or less profitable, but are the figures right?

And in this regard, as best I can judge, the FASB recommendations with respect to accounting procedures strike me as correct. And it's not clear to me what the purpose of Congress is in intervening in this particular procedure.

With respect to the tax code question, that's a very complex issue because the tax code, as it affects the allocation of capital within a multinational firm, is never simple. And every time you change one element, you change something else.

And the presumption that you could essentially calibrate taxes to somehow provide major incentives within a multinational corporation to move employment from overseas to domestic I'm not sure works.

I do not deny that you can set up taxes which would prevent employment going abroad. But that doesn't mean that it's coming back home. It just disappears.

Representative Stark. My question, Mr. Chairman, was relative not to labor, which I don't think we can control with the tax code. That will always be attractive to people who choose to outsource.

But when you can retain profits overseas and not pay taxes on them, that encourages a capital investment in addition to what the normal labor market——

Chairman Greenspan. Well, you're referring to the issue of bringing back capital and therefore, it would be invested in the United States?

The evidence on that, Congressman, is that capital investment in the United States is largely determined by the potential rate of return in the United States relative to the domestic cost of capital.

Our financial markets are sufficiently liquid and our corporations in large measure are not limited for cash flows.

So it's quite conceivable that if you change the tax code in a manner which induces a much larger flow of undistributed earnings from abroad to domestic affiliates, it's going to have very little effect on capital investment. It probably will increase the payment of dividends to shareholders.

In other words, what will happen is that money will come through the United States and go out to shareholders in general.

There's very little evidence that I've seen, even though I know that some of my friends have made calculations in this regard. I frankly find them most unpersuasive.

Representative Stark. Thank you very much.

Thank you, Mr. Chairman.

Senator Bennett. Yes. Senator Alexander.

Senator Alexander. Thank you, Mr. Chairman, for being here.

Mr. Chairman, I want to refer to your comments about hiring as we look to the future. And I want to ask specifically about up to 6 million or so people working in this country who I don't think we're counting when we figure out who is working and who is not working.

I'm referring to undocumented aliens or to illegal immigrants.

We have two reports each month about who is working. The employers' survey samples 400,000 people who are on payrolls, as I understand it.

The household survey is a telephone question of up to 60,000 people, asking in many different ways, do you have a job? Are you working?

And there's been a lot of discussion which Chairman Bennett has participated in about which is more accurate. My question is not that. My question is that in both these surveys, which I gather we use to decide how many people are working and how many are unemployed, I don't think we count about 6 million people who are working in America, and those are illegal immigrants.

Most estimates are that we have 8 to 10 million living in America who are not legally here. Most estimates are that about 6 million of those people are working.

Now I'm assuming they're not counted in the payroll survey because it's illegal to hire somebody who's illegally here.

So that's 6 million people who are not counted.

And I'm assuming they're not counted in the household survey because if you're legally here and you've got a phone call from the government, you're not likely to spend much time answering the questions about anything.

And the reason I ask these questions is, if the report says that we have 129 million people working in America today and we're not counting people, 6 million people—or up to 6 million people who are illegally here—what difference would that make in your estimates and projections.

Or in the household survey, if we're saying that we have 7.8 million people unemployed in America, but we have 6 million people illegally here, what does that say about our solutions for those unemployed persons?

Are we to assume that if those 6 million illegal immigrants were not here, that we'd have no unemployment in America? Are we understating or overstating our jobs and unemployment figures because we're not counting up to 6 million people who are illegally here and who are working?

Chairman Greenspan. Well, Senator, this issue has bedeviled statisticians—basically, the Bureau of Labor Statistics—for a long period of time.

The issue gets down to a few facts. The base of the payroll survey, which is monthly, as you point out, a survey of 400,000 establishments, is actually a quarterly posting of all employment that is subject to the unemployment insurance system, which we presume under the law is full coverage, but as you point out, of legal coverage.

Now the question really gets down to, when the individual companies submit their reports to the unemployment insurance system, do they include all people whom they have hired? Or do they include only those who they perceive to be legal?

The answer seems to be that they can't or shouldn't or probably can't, in general, make that distinction. And so, you have to assume that, presumably, people are working a plant, if they are illegal aliens, are counted.

The question of the household survey really is a two-pronged question. First, what the 60,000 sample does is basically try to get the proportion of people working within households as a percent of the non-institutional population, age 16 and older. Now, when that figure is calculated, they then multiply it by the estimate of the non-institutional population, which the Census releases.

I assume we have perfect numbers on legal immigration. But I have trouble finding them all the time. But, clearly, we are guessing on illegal immigration.

So that the aggregate number of employees depends on, one, the illegal immigration estimate in the population and two, the answer to the issue that you raise—when people are called in that 60,000 sample and there are illegal-employed people within that household, do they say they're employed?

Now the problem is that, when you put all of these data together, and you match the payroll data and the household data, it is difficult to find the wedge of illegal immigrants.

In other words, it doesn't show up in a manner which you can basically say, the reason why the household figure is this or the unemployment rate is that is illegal aliens; the bottom line is nobody knows for sure.

But the data are internally consistent, over the years, between the payroll data and the household data, and give roughly the same results.

And unless the illegal alien figure is not captured in equal proportions in both of these surveys, then we have to assume that the illegal aliens are being counted in large measure.

But the bottom line, as I said, is we don't know that and I think it would be a major advance in our statistical understanding if we'd get a much better handle on that question.

Senator Alexander. Thank you.

Senator Bennett. Mr. Hill.

Representative Hill. Thank you, Mr. Chairman.

Welcome, Chairman Greenspan. I would indicate that in the past you have said that deficits matter. Yesterday you said that they're not an immediate threat right now.

But you have also said that you have supported the idea of budget enforcement rules like PAYGO.

You've also endorsed the concept of permanent tax cuts. How do we get to the bottom of this deficit problem if you support permanent tax cuts and PAYGO rules that apply both to spending and tax cuts?

And I do have a second question that I would like to get out there, and I'd just throw it out there now and let you address yourself to it.

Back in February, when you were testifying before the Congressional committee, you generated a lot of telephone calls into my congressional office by suggesting that we cut Social Security in order to rectify the growing budget crisis.

And I would like for you to address that as well, if you would.

Chairman Greenspan. First of all, I argued strenuously and ineffectively before the Congress in September, 2002, not to allow the PAYGO rules and discretionary caps to expire because I thought that over the previous decade they had worked remarkably well, and indeed, were a major factor in constraining deficit expansion and, indeed, contributed largely to the contraction of the deficit.

I still believe that we need, before we get involved in budget negotiations, budget discussions, budget programming, to restore those budget rules because there is no way, that I'm aware of, which the Congress can appropriately allocate various priorities in the way in which 535 Members of the Congress can effectively come to a conclusion.

You have to have a mechanism to do that. And the best that has been adduced in recent decades has clearly been PAYGO.

I reconcile the issue of taxes and PAYGO by stipulating that, one, I visualize the PAYGO rules in place. But I would like to see— I don't have a vote, so I'm just expressing my own point of view— a lower level of spending, largely because we are going to be confronted with a very major increase——

Representative Hill. Well, where would you cut?

Chairman Greenspan. I could give you a long list of cuts that I would do, and I would submit to you that your telephone bill would go up immensely.

[Laughter.]

First of all, that is the issue of why we have budget committees and various different mechanisms by which the Congress comes together to take the limited resources that we have and effectively comes up with fitting some of the parts in the total.

Now, is that easy?

No. But I do think that the point that I have been making is that we have an unprecedented change occurring in the next decade with a doubling of the number of retirees. And that is going to have a huge impact on benefit payments and fiscal pressures.

Now I have argued over the years that Social Security, being a defined benefit program, requires change, but not a great deal of change because we know within limits what type of benefits will be paid under the existing statutes.

We don't have such confidence on Medicare. We cannot anticipate the processes that are going to occur in medical technology and in medical application so we do not have any reasonable way to come at what the costs are going to be.

We have a standard procedure where we say, benefits per retiree are going to rise X-percent faster than per-capita GDP. That's not, frankly, very helpful, nor very informative.

Because of the fact that of that great uncertainty, I have argued that it is essential that we have fiscal caution in this regard.

With respect to the issue of my allegedly saying that we ought to cut Social Security to fund the tax cuts, I object to the tying of those. I never made such a statement.

I have argued in favor of changes in benefits for a significant period of time wholly independently of whether the tax cut is continued or not continued and, indeed, even before the tax cut was enacted.

So to suggest that I am recommending cuts in Social Security to fund tax cuts, I find a rather misplaced conclusion.

All in all, I think the issue that is going to confront this country, unless we come to a far more organized way of looking at fiscal problems, is we're going to find that we get up to the year 2008, 2009, and the pressures from the financial markets are going to start to really begin to bite. And that's a little late in the game to resolve this issue, which I must say to you concerns me most because I don't believe that we can assure the next generation that what we have promised under current law, we can actually deliver in real terms.

And, if indeed, that is the case, it is incumbent on public policymakers to communicate that to those who will be retiring in 10 years, so that they can plan in a manner which is far more rational, rather than find that at the day they retire, the government says, whoops, we miscalculated. We cannot give you what we promised.

That's just unacceptable to me as public policy.

Senator Bennett. Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

Good morning, Chairman Greenspan. I find it interesting that you, as the previous Chairman of the Federal Reserve—I remember four, total—they've always advocated that we in the Congress spend less.

And really, the advice hasn't been taken.

Currently, our national debt is going up over $700 billion, and we're pursuing once again a policy of guns and butter and nobody seems to have much concern.

But I think the Fed participates in this. As long as you control the monopoly control over money and credit, and you can accommodate the Congress—I mean, if we spend, and nobody's going to buy those Treasury bills. We know if you want interest rates at 1 percent, you're going to buy them.

So, in a way, you're complicit in what we do here in the Congress. But I don't see that coming to an end with the monetary system that we have.

I do have a question dealing with your statement in the first paragraph about rising wealth contributing to the recovery.

This last recession has been written about quite extensively as being unique, that it came about not because you raised interest rates as the traditional—as it is traditionally for the Fed to raise rates. We go into a recession. Then there's liquidation and debt is wiped off the books. Then there's a restarting.

This time, it just stopped because people ran out of steam. There wasn't enough consumer purchasing power and we had a recession.

But you very, very quickly and efficiently came in and lowered interest rates very aggressively and prevented the conventional liquidation and the corrections that have come in the previous recessions.

And Congress didn't hesitate for a minute to follow in its Keynesian path and rapidly and excessively raise spending.

But in addition to this, we have this very unusual and unique form of financing our houses which has caused tremendous inflation in our housing prices through the financing of Fannie Mae and Freddie Mac, which in some ways the Fed participates and in many ways, the foreign central banks participate extensively in this.

Anyway, we have a housing bubble. Housing prices go up and that, I assume, participates in this wealth because the consumer has gone and borrowed sometimes more than their equity.

Of course, equity prices are soaring.

And that to me is like saying that we had great wealth when the NASDAQ was 5,000. And all of a sudden, that great wealthy dissipated rather quickly.

So I do not see how we can say that we have true wealth without savings that's created artificially by the excitement of easy money and easy credit and artificially rising prices. And then people go out and get into further debt.

To me, it seems like the bubble leaked and you patched it up quickly. So we're back on the same track again of very excessive spending, excessive borrowing, and we never had the liquidation.

What really are you thinking about when you're talking about the rising wealth that has helped in this recovery?

Chairman Greenspan. The term "wealth" in this context is a technical statistical term which is related solely to the question of the market value of the net assets of households.

Now one can argue whether or not the market values that are placed on claims on physical assets are high or low. Remember that all judgments of wealth essentially are discounted values of for-

ward-expected returns, and that a people's sense of risk aversion is a critical fact in determining where stock prices are and, hence, where that wealth is.

But having said that, whatever it is does impact, by all of the statistical analysis we are able to adduce, on consumer expenditures. And the reason for that is that people, when they become wealthier in paper terms as you would put it, do have collateral to borrow against and to spend, and they do.

And that has indeed been an important factor in consumer expenditures over the last decade.

Representative Paul. My question is, is it real collateral? That's the question.

Chairman Greenspan. Well, the point at issue is, it gets to the more fundamental question, if you're sitting out there with a big steel plant and you say, that is wealth, the question is, it's people's judgment as to the amounts of steel that will be produced and sold, and the profitability that will be engendered, that will determine the ongoing value of that steel plant.

And people's views can change quite dramatically, even if the physical plant doesn't change one iota, even if, indeed, the amount of steel they're producing and selling doesn't change.

So what I'm trying to get at here is that you're raising the much broader question with respect to how are assets valued in the market place. And we have rational and non-rational procedures by which those evaluations are made.

Representative Paul. I'm afraid we're confusing debt with assets. That's my contention.

Chairman Greenspan. Debt and assets are two wholly different things. The Federal Reserve, I will say, does not make that mistake.

[Laughter.]

Senator Bennett. Senator Sarbanes.

Senator Sarbanes. Thank you very much, Mr. Chairman. I want to join you in welcoming Chairman Greenspan before the Committee.

Mr. Chairman, I have a number of questions for you. I'll try to be brief in asking them. And if you could be brief in answering them, maybe we can run through the list, or come close to completing it.

The IMF is apparently urging the Fed to prepare the economy for higher rates so as to avoid financial market disruption, both domestically and abroad.

What is the IMF referring to in this urging?

Chairman Greenspan. I'm sorry? What is the IMF doing?

Senator Sarbanes. What are they referring to with this urging? What is the disruption both domestically and abroad that they're referring to?

Chairman Greenspan. I think they're referring to two things, although I don't know this because I haven't actually seen the detail and they may explain it in more detail.

But in 1994, for example, when we moved 300 basis points, we did create a lot of movement in the market place. And I think that there is a concern that because in the last 10 years, the international financial system has expanded to such a large extent, that

we're now more inter-related than previously. And obviously, any significant problem in the United States' financial markets would inevitably spill over into the rest of the world.

I don't know what the IMF is saying because I haven't read what that is.

However, it's also important to understand that the degree of sophistication that has emerged in the last decade in our financial markets has induced all of the participants to effectively make a judgment as to where they think interest rates are going and to effectively hedge those positions.

So that whatever one may say about where they think Federal Reserve policy is going or interest rates in general are going, I will say to you that, for the average, it's effectively hedged.

And the question has got to be whether markets move or less than are currently being discounted.

Senator Sarbanes. Now as of this August, you will have been Chairman of the Fed for 17 years, I believe. Looking back over your 17-year tenure, once the Fed starts moving the rates up, how long does that period usually last?

Chairman Greenspan. Well, first of all, there's an implication that once we start, we continue for a protracted period.

Senator Sarbanes. Is that not the case?

Chairman Greenspan. That is not the case. There have been many occasions in which we have made one move and stopped.

But, on average——

Senator Sarbanes. Well, if you do a two-step, for how long does it usually last?

[Laughter.]

Chairman Greenspan. I don't know. But, on average, if you just look back over the period, when we've gone through protracted moves in either direction, it's usually a year or so.

But as I said in the very beginning, we do program analysis, if I may put it in those terms, with respect to strategies for moving rates in one direction or the other, and there is no timeframe that we essentially associate with that.

Senator Sarbanes. And once you start moving rates beyond the two-step, by about how much do you usually raise them up?

Chairman Greenspan. It varies.

Senator Sarbanes. What is the smallest amount by which you have raised rates once you've started raising them in the course of your tenure as Chairman?

Chairman Greenspan. I think it was 25 basis points, which was the short——

Senator Sarbanes. I'm trying to eliminate the one-step scenario.

Once you get to a two-step and you start raising them——

Chairman Greenspan. I have a general knowledge, but I'd much prefer to answer that for the record to get it exact, if I may.

Senator Sarbanes. Well, it would be helpful if you could submit that to us, Mr. Chairman.

[The written response appears in the Submissions for the Record on page 35.]

Would you regard the current levels of inflation as extraordinarily unusual in historic terms, and therefore, the economy has somehow been passing through a unique period?

Chairman Greenspan. I would, Senator.

Senator Sarbanes. What do you think is the more normal inflation rate?

Chairman Greenspan. Well, it's not that there is a more normal rate. I'm saying what we have gone through is a really quite extraordinary process in the last 20 years to diffuse inflation expectations in a way which I would have thought would have been extraordinarily difficult to do, looking at it from a 20 years ago viewpoint.

It's very apparent that globalization has been a very important characteristic of this, and I have no doubt that the ending of the Cold War and the opening up of many of the markets, especially in Europe, have been factors here.

But something different and unusual has been going on. The question that you're asking is, where do we go from here? And there's a certain sense of normality.

I'm not sure that there is a normal inflation rate. As far as we at the Fed are concerned, what we would like to see is the normal inflation rate, is price stability.

Senator Sarbanes. I see that my time is up. If I could just add one more question very quickly.

I notice that inflation-protected bonds are apparently selling at a rate that anticipates inflation of about 2½ to 3 percent as we move forward.

Is that correct?

Chairman Greenspan. The difference between the TIPS, which are inflation-indexed bonds, and the nominal Treasury rates, are the numbers which you are suggesting.

The problem is that that is not necessarily a pure forecast of price, largely because, as the liquidity in these inflation-indexed bonds has increased, their yields have gone lower than they would have gone and hence, the spread between the higher nominal rate and the TIPS rate has opened up more than one would expect is wholly the consequence of inflation.

We don't know what the size of that liquidity change is. We do suspect, however, that there's an upward bias in that measure of inflation expectation.

We use it and we evaluate it and we try to understand it. We also use a lot of other indicators of underlying inflation expectations. And when they all come together, we feel comfortable. When they don't, we try to determine what are the differences and what is likely to be the truth.

Senator Sarbanes. Thank you, Mr. Chairman.

Senator Bennett. Mr. English.

Representative English. Thank you, Mr. Chairman.

Chairman Greenspan, thank you very much for giving us this opportunity today. I have two rather narrower questions that I would like to pose and I will simply pose them and allow you to take them wherever you wish.

The first of these, you note in your testimony the importance of capital investment in the current recovery.

What I guess I would be curious to have you comment on is, given the tax legislation that passed last year, and some of the specific incentives for capital investment that were included in them, do you feel comfortable making a causal connection between a higher level of capital investment and some of the incentives that were included in that bill?

And specially, if Congress were to act to continue those incentives and make them permanent, would that have a potentially beneficial impact on the economy?

My second question has to do with another side of the recovery, specifically in manufacturing.

I think that the indicators right now, as you've noted, are that manufacturing is recovering. But I am concerned about the cost of some of the inputs for manufacturing.

Specifically, steel scrap, coke for some aspects of the steel industry, and for manufacturing generally, the high cost of energy.

And I wonder if you feel there is any evidence to suggest that those higher costs potentially will have an impact on manufacturing, have a potential to slow down the recovery. And do you anticipate that those costs may come down?

And I'm particularly interested in any comment you would feel comfortably offering on the issue of steel scrap.

And I thank you.

Chairman Greenspan. Congressman, the evidence does suggest that the partial expensing element in the tax bill is having an impact, in part because it's limited.

In other words, that it will come to an end, as I recall, at the end of this year. But it's probably the most potent factor involved.

Over the longer run, I suspect, although it is difficult to prove, that the lower tax on dividends will ultimately flow through into higher capital values which indirectly will impact on capital investment.

So the answer to your general question is, yes, I think there is evidence that capital investment has been affected.

With respect to the steel inputs, it's not that long ago that we had the Mesabi Range operating at a fraction of its capacity. Now, everything is going flat out and everybody wants to buy everything they can.

And the one thing I have never thought we would have a shortage of is coke. And coke prices, as you know, have moved very materially.

And if you really wanted to get to the bottom of the heap, what you would call scrap, which has really been the star price performer, and essentially, what all of this does, both the issue of iron requirements and steel scrap generally, is a huge increase in metallic demands around the world, of which China has been a very material element.

It's hard to tell what the level of actual consumption of metallic materials is in China because we've had big surges in prices not only in steel, but in aluminum, copper, and other metals as well.

The rate of increase on the shipments strikes me as unlikely to be matching a consumption pattern. History tells me that there's some inventory building in that process.

And therefore, it's hard for me to believe that the surge in steel scrap prices, which seems to be tilting over now, incidentally, is one that's going to resume and continue higher.

So my general view is that the underlying costs in the steel industry have induced a lot of the producers, especially those with electric furnaces, which essentially use scrap, to put premiums on prices and create some significant problems for metal-using industries.

And it has indeed induced the slow-down.

When you insert the natural gas issue on top of that, it's really becoming a serious problem. And I do think it is an element slowing down durable goods manufacturing over the long run.

Fortunately, in the short run, things seem to be coming back reasonably well. And as you know, the order books of the steel companies are flat out. And indeed, recently, one of the major motor vehicle manufacturers acquiesced in essentially taking a premium price of steel, even though it wasn't in their contract.

That tells me something very unusual is going on here.

Representative English. Thank you, Mr. Chairman.

Senator Bennett. Mr. Ryan.

Representative Ryan. Thank you. Well, Mr. English asked one of the questions I wanted to ask. So I'm going to take a different tack.

But I think if you take a look at the last year, over monetary and fiscal policy, I think it's a good story that can be told.

Number one, when the tax cuts were announced last January, the markets responded favorably. When we got more into the serious business of actually writing the legislation in the spring, the markets clearly took that as a serious note. And when they passed in July, I think we saw a great recovery where we had the greatest quarter growth in 20 years.

Combine that with the fact that we had very accommodative monetary policy with expansion of the monetary base, I think what you saw last year was a great success story in economic expansion to where we are today, where consumption is growing well, where we have business capital expenditures growing at double digits. We have exports growing at double digits.

To the point where we are today where the foretold employment expansion to the household survey tells us a good story. And even now, the employment survey has shown that we've created 500,000 jobs since January, and to the point where we now see that disinflation or deflation is off of the horizon.

My question to you, Mr. Chairman, is this. Now that we do see that essentially, deflation is off the horizon, why does the Fed seem to be ignoring sensitive market signals like gold, commodities, and the steep, upward-sloping yield curve?

These signals have traditionally placed advanced warnings of excess liquidity and inflation. Shouldn't the Fed at this time be looking at normalizing the federal funds rate?

After all, having an economy that's growing an average of about 5 percent and a Fed funds rate at 1 percent seems to be an unsustainable posture over the long run.

Wouldn't it be prudent to have small adjustments now, say before gold hits $500, so that we can avoid larger adjustments in the future, such as what took place in 1994?

Chairman Greenspan. Congressman, I can't obviously stipulate where the Federal Open Market Committee is going to go or not go because, one, while I can guess, I'm not sure. And in any event, if I could guess, I shouldn't say what I guess.

But the crucial difference between now and in the past is an extraordinary productivity acceleration.

Remember that if you take the non-financial business structure of our domestic economy, you can disaggregate it in a manner to get the causes of price change.

In other words, we know that two-thirds of consolidated costs are unit labor costs. We know what proportion are import costs and if you take the non-energy part of our non-financial business, we know what parts are energy costs.

So that we can see the structure of costs moving.

What is different from the past is that, in the past, we had very little productivity gain and a very rapid response.

Here, what we are finding is that productivity is running in excess of compensation of employment, or has been, which means that unit-labor costs are falling.

To be sure, they're falling at a pace less than had been the case last year, but they are still falling. And that means that the price pressures are not anywhere near what they would be under normal circumstances.

And when you look at the past, the issue of addressing a particular potential inflation problem has got to take into consideration all of the various elements involved in that current situation. And remember that any particular monetary policy that you embark upon has risks. And you have to balance the risks against the benefits.

When you have the benefit of a very significant increase in output per hour, it means that you can go in a much more measured pace than you would be required to go in the past.

And the reason why we have stayed at a 1 percent federal funds rate over all of this period is not that we thought that inflation had gone away and that it was no longer a problem. It's that we believe that given the underlying structure of costs and prices and profitability, that the emergence of inflation at a reasonably rapid pace, which would create great concern on our part, was nowhere on the horizon.

And that, therefore, we could calibrate monetary policy in a way that we did not have to take undue risks, which invariably you do no matter what policy is. And that essentially is what our recent history has been.

Where we go from here is an issue that the Federal Open Market Committee will address in a couple of weeks and thereafter.

Representative Ryan. Well, if and when you adjust or increase the Fed rate this year, will you make that decision based on the economy or based on the budget?

Chairman Greenspan. I'm sorry? On the economy or——

Representative Ryan. Or based on the budget that Congress passes. The question is, some will try to link any potential increase

to what the budget deficit is or what the budget that passes the Congress is versus whether or not you're going to look at all the other things, the factors in the economy.

Chairman Greenspan. We look at the economy only. But to the extent that the budget affects the economy, that then becomes part. But we don't, as you put it, link monetary policy to whatever the Congress does with respect to fiscal policy.

Representative Ryan. Thank you.

Senator Bennett. Senator Collins.

Senator Collins. Thank you.

Good morning, Mr. Chairman. I'd like to get your thoughts on an issue that is very important to my home state of Maine. And that is the loss of manufacturing jobs that we're seeing.

Over the past 3 years, Maine has seen some 18,000 manufacturing jobs disappear. It has really hurt our economy.

In fact, we've had the greatest loss on a percentage basis of manufacturing jobs of any state.

The recent news on the jobs front has been very encouraging, but it's unlikely to help a lot of these individuals who worked in our paper mills and other factories in Maine for many, many years.

And I want to point out that I realize that job losses in the manufacturing sector are not a new phenomenon. If you look back from World War II on, the percentage of employment in the manufacturing sector has declined as a share of total manufacturing. And in absolute terms, the number of American manufacturing jobs has fallen each year since 1997.

Recognizing that the job losses in the manufacturing sector reflects a long-term trend, I would welcome your thoughts on what you see as the outlook for the American manufacturing sector and what policy options you believe Congress should be looking at to help stem the loss of jobs in this very important sector.

And just one final comment.

Another reason that this is of such great concern to me is the new jobs that are being developed, at least in my state, pay far lower wages and have fewer benefits than the relatively high-wage manufacturing jobs that we're losing.

Chairman Greenspan. Senator, as you point out quite correctly, this is a long-term phenomenon and it's essentially the result of two long-term very strong trends.

One is that this economy is inexorably becoming more conceptual. That is, an ever greater proportion of our gross domestic product is made up of ideas and less in the way of physical things.

And obviously, transistor radios do what large Stromberg Carlsons used to do in the 1930s. And there's all sorts of miniaturizing and essentially eliminating physical things in the value-added, in the sense that it's our ideas that have created so much value.

For example, the identification of the possibility of the transistor itself has induced a huge increase in wealth in the sense of what it has reproduced.

On top of this, and I might add, as a consequence of this, with less physical things, manufacturing per se has gradually reduced its proportion of value-added in the total GDP.

More importantly, however, has been the extraordinary advance in productivity in manufacturing. It is just awesome what people have been able to do.

The regrettable secondary collateral damage, if I may put it that way, of that process is that they need fewer and fewer people to produce any particular level of output.

And that process will continue. But I must say that with the turn-around in the economy, and we're beginning to see, obviously, significant improvement in manufacturing in recent months, we're fortunately in an up-cycle and I think that things will improve over the longer run.

What public policy should be in this regard I think is a very complex issue, and I don't think I could address it in any way which, if I knew what to do, I could express it very simply.

But not knowing, all I can do is give you various alternatives. And I'd be glad to do that at some time if you'd like.

Senator Collins. That would be very helpful. Thank you.

[The written response appears in the Submissions for the Record on page 37.]

Senator Bennett. Thank you.

Ms. Dunn.

Representative Dunn. Thank you very much, Mr. Chairman. And thank you, Mr. Chairman, for coming to meet with us today.

It's so useful to the perspective that we need to develop as we handle some of these issues in Congress. And I've been interested in what you've said on a number of the questions, particularly your perspective on the unemployment compensation problem that we now face.

I come from a part of the country where the economy is rather fragile, where unemployment continues to stay higher than in almost every other state in the nation, Washington State.

I just want to make sure that I represent my area and urge caution to the Fed as they consider raising the federal funds rate.

It would hit our region I think very hard and perhaps put a chill on what is beginning to bubble up in terms of an emerging vitality that is far behind the rest of the country.

I'd like your thoughts on whether we should take a cautious approach to raising interest rates at a time like this in my state.

And secondly, every day when I wake up and listen to the news, I hear about the number of jobs that have been lost or the unemployment rate. Or recently, in the recent news, more happy news—308,000 new jobs being created.

Because of our situation with rising productivity at the same time that we're not increasing new jobs in the way that many of us would like to be, do you think that we should no longer be using the new jobs created measurement to indicate the health of our economy?

And my last question is, once before when you were here, I think in this very room, you talked to us about a way of helping, not solving, but helping the outsourcing problem, but also the job loss and manufacturing and in trade-related industries. You talked about increasing TAA to help handle some of this retraining.

And I'm wondering what you think about where we stand on TAA, whether we should be covering services, whether you think

that we're at the proper point or we ought to pay more attention to that.

Thank you.

Chairman Greenspan. Well, with respect to the issue of trade assistance, I've gradually changed my view on this issue.

First of all, that we ought to assist those who, through no fault of their own, happen to be in industries which are under significant international competitive pressure, I think ought to be a priority in this nation.

But I wonder whether we can actually, in any real sense, identify the cause of a job that is lost, whether it is productivity, imports, outsourcing, or a number of various things.

And that's the reason why, I should think, policy ought to be directed largely, so far as income support is concerned, through the unemployment insurance system.

The issue of training is a different issue, largely because as you get an ever-increasing pace of change in our economy, in the world economy, the old notion of getting out of high school or even college and having a job for the rest of your life is no longer the credible option.

And as a consequence, that means that people have to have broad general training in school which enables them to change professions if necessary.

In other words, the nature of education is, of necessity, changing, and the role of community colleges, which largely tend to be focused on how do you go from one profession to another, has undergone explosive growth.

And I think we are addressing the issue of the instabilities that inevitably occur as a consequence of creative destruction.

I would say the training aspects of trade assistance should be integrated as best we can with other job loss training programs.

In other words, to make training as a consequence of imports different from what we do with people who lose jobs because of increased technology, I think, is an awkward public policy structure. And if we could consolidate the issue and recognize a job loss is a job loss and that people have got to get to the next job, it doesn't matter why they lost their job.

The main issue is what do we do as public policy. And I would coordinate or even consolidate a lot of these various programs to address them as a single issue, not as disparate issues.

Representative Dunn. Then the question should be, would we be using jobs created as a measure of the health of our country?

Chairman Greenspan. Sorry, I forgot to mention that.

New jobs are a measure of the health of the economy. As I pointed out in my prepared remarks, there seems to have been a remarkable lack of anticipatory aggressiveness towards a change in economic activity, which usually one associates with people building new plant, hiring new workers in anticipation of changes that are occurring.

There's been very little of that until perhaps very recently. And if you're looking for a measure of vitality of a growing economy, you'll often find that capital investment in areas in which orders are not immediately on the horizon, and the hiring of people, when you don't necessarily need them to produce what's going to occur

a month from now, are measures of confidence, and in that regard, measures of the vitality of the business process itself.

Senator Bennett. Thank you.

Senator Sununu.

Senator Sununu. Thank you, Mr. Chairman.

Chairman Greenspan, yesterday, you began giving testimony to the Banking Committee a little bit after 2:30. And at that point, the markets were nominally up for the day. And over the next 45 minutes or so, the markets dropped about 125 points.

What types of assumptions were being made by those selling off stocks? And do you think that their interpretations of your remarks were appropriate?

Chairman Greenspan. As I read in the papers this morning, the implication was that whatever I said, they interpreted as at some point higher interest rates. And that one would presume that, under the normal discounting procedures of forward expectations of earnings, stock prices go down. Now, are they right or wrong? I don't know.

[Laughter.]

Senator Sununu. That was good.

[Laughter.]

Is there any reason for us to be optimistic? Have you seen any patterns or concrete steps in the last several months to provide optimism that over the next 2 to 3 years, we will see a substantive removal of capital controls on the Chinese currency?

Chairman Greenspan. I do, Senator. I think that China has moved remarkably from a centrally-planned system to certain aspects of market capitalism which have turned out to be quite vital. But they are still subject to a very significant amount of central control. Obviously, their state-run enterprises are still big issues there. They are finding that the dynamism, the strictly free-market part of the system, is creating distortions all throughout the remainder of the economy, which is largely rigidified because of the central planning characteristic.

To their credit, they're aware of this. One of the problems they have, as you know, is that they have imposed capital controls on the part of domestic residents of China on the purchase of foreign assets. And that creates an upward bias in the Yuan relative to the U.S. dollar to which it is effectively pegged.

And at some point, that's going to break down and, indeed, I think they're already engaged in processes to weaken those capital controls. And at the end of the day, you really won't know where the true value of the Yuan should be until those controls are gone.

Senator Sununu. What are the most important next steps for them to take in that process?

Chairman Greenspan. In my judgment, it would be basically to gradually remove controls and see what happens to capital flows as a consequence and be able to calibrate the degree of their intervention in the marketplace, which has largely been through the purchase of U.S. Treasury instruments to support the suppressed value of their currency.

Neither of those paths are projectable over the longer run and it's only a matter of time that the policies which they're clearly em-

barked upon will lead them, as indeed they have said, to a more flexible exchange rate structure.

Senator Sununu. There have been some discussions on both the House and Senate side, in the respective banking committees, about the federal role of regulating insurance.

The House has had a number of hearings on this and recently, the Chairman of the House Banking Committee indicated an interest in moving legislation that would set national standards for regulating insurance, in particular, price and form on insurance products.

There have also been proposals out that go a little further to establish an optional federal charter for insurers, insurance underwriters, along the lines of our optional federal charter system for federal banks.

Do you think that that type of an optional federal charter regulatory structure is appropriate for the insurance industry?

Chairman Greenspan. We at the Fed have not taken a position on that, nor have I, largely because it's a very complex question with respect to state versus federal regulation.

And I don't think we've got very much to add to that that's not already in the public domain.

Senator Sununu. Mr. Chairman, since he didn't answer that question, could I ask one shorter one?

Senator Bennett. Surely.

Senator Sununu. Chairman Greenspan——

Chairman Bennett. We've dwindled down to the precious few, so I can be more lenient now than I was when we had the whole panel here.

Senator Sununu. When you were asked about expensing of stock options, the phrase that I wrote down that I believe you used was that it would be a bad mistake for Congress to impede FASB.

Now that struck me as a fairly unusual phrase. Typically, you'd be more likely to express displeasure with words like "awkward" or "unusual" or "poorly-timed," "not optimally timed," something like that. "Bad mistake" seemed a little bit—well, refreshingly direct.

Did you err in choosing your words, and would you like to elaborate on precisely what you meant by either "bad" or "mistake"?

[Laughter.]

Chairman Greenspan. I chose my words appropriately and I think the Congress would err in going forward in endeavoring to impede FASB in its particular activities.

Senator Sununu. Thank you very much.

Senator Bennett. Thank you, Mr. Chairman.

And I thank the Members of the Committee who have heeded my admonition to stay within their limits, so that we have, in fact, acted a little more expeditiously than we might have anticipated.

May I ask you a question perhaps stimulated by some of the comments that have been made in the election season? But are we in a wage recession, in your opinion?

Chairman Greenspan. You mean are wages going down in real terms, in that sense?

Senator Bennett. Yes.

Chairman Greenspan. I think we have been in a period where real compensation, and especially real wages, have been going up very moderately, if at all.

I think that's about to change, as I indicated in my prepared remarks, because the consequence of that has been that virtually all of the gains in productivity have ended up in rising profit margins and hence, in a decline in the portion of the national income going to compensation of employees.

History tells us that the range in which the proportions of profits versus compensation move are reasonably narrow and without any significant long-term trend.

And I suspect that what we're about to find is that, with margins now up to fairly high levels, competition is going to start to move in because, remember, with wages moderate and profits reasonably high, the mark-up from wages, which is the major cost, to profits, suggests a fairly considerable amount of opportunities on the part of business management for profits.

And the way that happens historically is businesses start to hire and bid up wages in the process, and that's the process by which compensation of employees rises relative to the national income, and eventually starts a new cycle.

So I don't know whether I'd use the term "wage recession" but whatever one terms what has been going on, it is about to change.

Senator Bennett. We are faced here in the Congress with the decision as to whether or not to make the President's tax cuts permanent. And you've indicated support for that, that they should be made permanent.

But let us suppose we are unable to do that. Do you have any feelings or forecast as to what might happen if, in fact, the tax cuts did expire this year?

Chairman Greenspan. Obviously, if the tax cuts have been helpful, which I think they have been, it will have some negative effect.

But there are other forces in the economy which have been developing and I would presume and hope that in the event that the tax cuts are not extended, that the momentum of the economy will be enough to carry us into next year at a reasonably good pace.

But while we can seek to look over the horizon, it doesn't necessarily follow that we can see all that far. Economists tend to be fairly explicit in making long-term forecasts 2, 3 and 4 years out.

We are fortunate in that there is no service out there which collects all these forecasts and reports them back to us 2 years later.

It would be a major embarrassment to most of us forecasters, probably all, if I may put it exactly.

Senator Bennett. I once was told, and often repeat, that the way to be a competent forecaster is give them a date or give them a number. But never give them both.

[Laughter.]

Chairman Greenspan. That is sage advice, Mr. Chairman.

Senator Bennett. My own expectation is that the markets generally have assumed that the tax cuts will, in fact, stay in place and that there would be a negative reaction in the markets if that assumption were to prove not to be the case.

Is that a reasonable position?

Chairman Greenspan. Well, certainly, if the markets are, in fact, presuming they remain in effect, if they do not, I think you do, by definition, get a market reaction.

Senator Bennett. One last question for an issue that you raised the last time you were here.

I was a little surprised that you raised it, because it's not something one expects from the Fed, but that I'm very glad that you raised it, because I think it is something that will impact the economy to a degree that requires the kind of visibility that your testimony gave it.

You got into it a little in your exchange with Mr. English. This is the impact of higher energy prices, specifically natural gas.

Natural gas has become the fuel of choice everywhere. And we cannot repeal the law of supply and demand. So that the price of natural gas has become elevated and looks like it will continue to rise if we can't somehow relieve the pressure on the demand by going to alternative fuels such as nuclear to generate electricity, or some other form.

We are now, perhaps in response to the comments you made, we are now changing our ports to allow the importation of liquefied natural gas. You made the point that if we were going to import this particular fossil fuel, we had to do it from Canada or Mexico because that's the only place where we can get it in by pipeline.

Now we're making a significant capital investment at a number of ports to allow the importation of LNG. But we have significant natural gas in the United States on our public lands and elsewhere, with a particularly large supply up in Alaska that we don't seem to be able to get down here.

Could you once again address the question of the shortage of natural gas? Or rather, the increased demand for natural gas and therefore, the increased prices of natural gas and what you see that might do in the economy?

Chairman Greenspan. Well, Mr. Chairman, you're quite correct. One of the reasons why we took a look at natural gas is that if our mandate is to look at the economy overall, it's important that we know where the pressure points are and try to identify them because it's only by evaluating those pressure points that we get a full context of what the economy is likely to do over a year, 2 years, or 3 years, where our policy processes focus.

Natural gas growth in the United States, as you know, has been quite significant and in part, as you point out, because it's the fuel of choice for so many different reasons, and it will continue to be so, largely because electric generation turbines—the ones on the order books—are exceptionally heavy users of natural gas.

So we know that that's what the demand is going to be out there.

Despite fairly extensive drilling in the United States, the reservoirs continue to decline fairly significantly, in part because the technology is so good. So we're having trouble increasing the net marketed production in this country.

When we had that problem in oil, we had the capability of very quickly importing either crude or products from all over the world because the trade in oil and oil products is about twice the volume relative to world consumption that it is for natural gas.

And it occurs to me that looking at the various supply and demand forces here, the only flexible alternative that we have got is to look at these so-called vast reservoirs of stranded gas around the world and find ways to import it into the United States in liquefied natural gas form, which gives us a safety valve, in effect, for the shortages that periodically occur and shortages which create sharp spikes in natural gas prices with great significant problems.

People constructed industrial facilities in this country largely on the expectation that gas prices would stay in the area of $2 per million BTU. And indeed, long-term futures markets exhibited that price.

And the overall structure of industries which use natural gas pre-suppose that that price would prevail over the long run. Now we, of course, are aware that the spot price is up in the $5 area. But more importantly, the 6-year futures price has doubled. And this suggests that the shortages which we are gradually beginning to get a sense of are now projected longer term.

And that's going to mean that the structure of the gas-using industry in the United States is going to change. And what we need to do is get in place as soon as we can the capability of fairly substantial imports that enable our manufacturers who use natural gas to compete internationally.

We are losing a lot of business, especially in the chemical-related areas, because we can't compete at these prices. And we've got to find a way to bring down the price of gas. And the only way that I know of is essentially to open us to the world supplies, which are substantial and whose prices are well below our prices.

Senator Bennett. Thank you very much. I will continue to push for the pipeline in Alaska for natural gas, however, because I think we've got a lot up there that we're not getting.

Ms. Dunn, you have been the most persistent in hanging in there. Do you have a last question for the Chairman before we leave?

Representative Dunn. I do have one, if the Chairman is willing to take one more question. It has to do with trade.

In your testimony, you say that the sharp rise in exports contributed importantly to the acceleration of real GDP over 2003.

And I think my worry right now is that there seems to be a mood in the Congress against free trade. I'm worried about it. It has to do with outsourcing. It has to do with invasion of sovereignty. It has to do with manufacturing jobs.

And I just think that we have to figure out a way to explain to people why free, and fair, trade is important to our economy.

I wonder if you have any thoughts on that.

Chairman Greenspan. What is remarkable is that the abstract idea of free trade, which developed basically amongst the so-called classical economists of the latter part of the 18th century and early 19th century, showed that they began to understand a process embodied in Adam Smith's "Wealth of Nations," which is a tribute to how ideas can be spread.

And it's a very complex and a very difficult idea to push. But American society has essentially accepted free trade.

To be sure, in recent years, there have been growing concerns about it, in part because of the fact that trade has opened up so

dramatically, so that furthering the expansion of trade is not that easy to do. And the way I'd like to put it is that the low-hanging fruit of trade negotiations has already been picked. And it is difficult to find new avenues to continue to expand. And there's lots of friction, because by the very nature of the process, there are winners and losers.

And we've got to, as I indicated earlier, find a way to address the problems that are associated with those who lose jobs or are disadvantaged in business as a consequence of this very dynamic process which we characterize as global free trade and of which the United States has been the largest beneficiary.

It has been a major factor in the extraordinary increase in American standards of living since the end of World War II.

And one of the things that the statistics tell us is that our economy has been capable of maintaining a very high job input in a sense that, on average, we've employed more than 94 percent of our work force decade-in and decade-out, and real wages have increased inexorably decade after decade.

And this has occurred irrespective of whether or not we have trade surpluses or trade deficits, or whether outsourcing was high or low.

There are more fundamental forces in our economy which create increased standards of living. And free trade has been a very major facilitator of those forces.

And our ability to basically engage in increasing specialization of labor has, decade after decade, created ever higher standards of living for American households.

When I was very young and just got into business, my recollection was that little more than half the households owned a car, and none to speak of owned more than one.

Now there are as many cars and trucks in households as there are people of driving age. And this is an extraordinary change. And you can go product by product. This is the result of our ability to engage the world as a whole and come up with great benefits as a consequence.

Representative Dunn. Thank you, Mr. Chairman.

Senator Bennett. Thank you very much, Mr. Chairman. We appreciate your candor and your wisdom.

The hearing is adjourned.

Chairman Greenspan. Thank you very much, Mr. Chairman.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF SENATOR ROBERT F. BENNETT, CHAIRMAN

Good morning and welcome to today's hearing. We are pleased to have as our guest today Chairman Alan Greenspan of the Federal Reserve. We always appreciate your views on the current economic situation, as well as your broad perspective on the economic and fiscal issues facing Congress.

Mr. Chairman, today you visit us at a time of good economic news. The economy is growing rapidly and adding new jobs, thanks to well-timed tax relief, aggressive Fed policy, and the amazing resilience of the American economy.

What a difference a year makes. A year ago, Mr. Chairman, you appeared before this committee, and we talked a great deal about deflation. Today, we meet amid speculation about inflation.

Last week we learned that consumer prices have been rising faster than expected. Moreover, commodity prices are much higher than they were a year ago, due to the strengthening world economy and a lower dollar. Higher commodity prices may eventually lead to higher consumer and producer prices—as we have already seen with gasoline—but the real question is whether they signal broader price increases ahead.

In the sometimes topsy-turvy world of economics, the bond market has treated recent gains in employment as bad news, driving bond prices down and interest rates up. Employment growth is, of course, an unmitigated good for the economy, but it does sharpen the question of how long the Fed will be able to maintain such low interest rates and how and when the Fed may move to a more neutral policy stance. We welcome any insight you can provide on this issue.

We also welcome your thoughts on the housing market. Housing has been remarkably strong in recent years, boosting the recovery and building wealth for millions of American families. Low mortgage interest rates have been key to housing's strength, lifting home prices in much of the nation, but also raising the cost of living for new home buyers. We need to understand how rising home prices may contribute to inflation. And looking ahead, we also need to understand how rising interest rates may affect the housing market.

With that, we welcome you, Chairman Greenspan, and look forward to your testimony.

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, VICE CHAIRMAN

It gives me great pleasure to join in welcoming Chairman Greenspan once again before the Joint Economic Committee.

The evidence shows that the U.S. economy has displayed amazing resilience in recent years, and has now emerged from a painful adjustment process. The bursting of the stock market and technology bubbles began in 2000. The subsequent economic slowdown and recession, terrorist attacks, and wars harmed the economy, but did not prevent the current economic expansion, which began in November of 2001.

The economic data released in recent quarters indicate that the U.S. economy is growing at a healthy rate. Over the last half of 2003, economic growth adjusted for inflation was 6 percent. This recent pick-up in the economy was expected for some time, but had been delayed by weakness in business investment.

However, the long-awaited rebound in business investment is now underway, and has boosted the economy and led to a more balanced pattern of economic expansion. For example, in the last two quarters of 2003, investment in equipment and software increased at rates in excess of 15 percent. The increases in investment have contributed to a strong recovery in manufacturing activity.

Meanwhile, consumption and housing activity continue to hold up well. Productivity is very strong and inflation is under control. Recent data indicate that payroll employment growth has resumed. Independent economists have noted that tax relief and accommodative monetary policy have made important contributions to the recent strength of the economy.

The Blue Chip Consensus forecast is that the U.S. economy will grow at an inflation-adjusted rate of nearly 5 percent this year. The return to sustained and healthy economic growth is a tribute to the flexibility and resilience of the American people and economy.

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Thank you, Chairman Bennett. I want to welcome Chairman Greenspan and thank him for testifying here today.

In January, the Federal Reserve's Open Market Committee signaled a willingness to consider hiking interest rates. The questions on everyone's minds here today are: When will interest rates rise, by how much, and how quickly? We will all be reading between the lines of your statement for the clues that will answer these questions.

Consumer prices rose sharply last month, sparking inflation fears in some quarters. The Fed has committed itself to "be patient" in considering rate hikes. Certainly, it will take more than a month's worth of data to know if the inflation threat is real. It seems to me that the labor market is still weak enough that the Fed can afford to be very patient. But I am interested in hearing more from Chairman Greenspan today about the inflationary pressures we face.

Concerns about a blip in inflation shouldn't distract us from the critical task of putting people back to work and keeping the economy growing. l hope, Chairman Greenspan, that you will be able to reassure us that the Fed is committed to getting the economy back to full employment as quickly as possible, and avoiding the danger of fighting phantom inflation.

Job growth has only recently shown some signs of recovery and wage growth has been stagnant. Although the recession officially ended nearly 2½ years ago, we still have a payroll employment gap of 1.8 million jobs since President Bush took office. We haven't seen such persistent job loss since the 1930s.

Leading forecasters, including the Federal Reserve, expect the economy to post solid economic growth this year, with inflation remaining relatively low. However, that growth is not expected to be enough to substantially reduce the unemployment rate. The unemployment rate edged up slightly to 5.7 percent in March—more than 8 million Americans remain unemployed, with 2 million out of work for 6 months or more. While 308,000 payroll jobs were created last month, this was the first significant job gain of the entire Bush presidency.

We are still in a deep hole and we can't really talk about a jobs recovery until we see robust job creation for several months. In the meantime, Congress can do something now to help the long-term unemployed. Even though jobs grew last month, long-term unemployment rose again. An extension of unemployment benefits has gained support from bipartisan majorities in both houses of Congress. Chairman Greenspan, you testified again last month that you support such an extension, as you have in the past, "in times like this."

But House Republicans have thwarted efforts by Democrats to help nearly three million unemployed workers and their families avoid financial ruin by extending temporary federal jobless benefits for the next six months and retroactively for the past three months. The Republican leadership has made this the "do-nothing for unemployed workers" Congress. The long-term jobless deserve additional unemployment benefits now—the President and the Republican-controlled Congress should just do it.

I look forward to Chairman Greenspan's testimony today.

PREPARED STATEMENT OF HONORABLE ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Chairman and members of the committee, I am pleased to be here today to offer my views on the outlook for the U.S. economy.

The economy appears to have emerged around the middle of last year from an extended stretch of subpar growth and entered a period of more vigorous expansion. After having risen at an annual rate of 2½ percent in the first half of last year, real GDP increased at an annual pace of more than 6 percent in the second half. Aided by tax cuts, low interest rates, and rising wealth, household spending contin-

ued to post sizable gains last year. In addition, an upturn in business investment, which followed several years of lackluster performance, and a sharp rise in exports contributed importantly to the acceleration in real GDP over 2003.

Although real GDP is not likely to continue advancing at the same pace as in the second half of 2003, recent data indicate that growth of activity has remained robust thus far this year. Household spending has continued to move up, and residential home sales and construction remain at elevated levels. In addition, the improvement in business activity has become more widespread. In the industrial sector, nearly two-thirds of the industries that make up the index of industrial production have experienced an increase in output over the past three months. More broadly, indicators of business investment point to increases in spending for many types of capital equipment. And importantly, the latest employment figures suggest that businesses are becoming more willing to add to their workforces, with the result that the labor market now appears to be gradually improving after a protracted period of weakness.

Looking forward, the prospects for sustaining solid economic growth in the period ahead are good. Monetary policy remains quite accommodative, with short-term real interest rates still close to zero. In addition, fiscal policy will likely continue to provide considerable impetus to domestic spending through the end of this year.

Importantly, the caution among business executives that had previously led them to limit their capital expenditures appears to be giving way to a growing confidence in the durability of the expansion. That confidence has, no doubt, been bolstered by favorable borrowing conditions, ongoing improvements in efficiency, and rising profitability, which have put many firms on a more solid financial footing.

Nevertheless, some of the strains that accompanied the difficult business environment of the past several years apparently still linger. Although businesses are replacing obsolescent equipment at an accelerated pace, many managers continue to exhibit an unusual reluctance to anticipate and prepare for future orders by adding to their capital stock. Despite a dramatic increase in cash flow, business fixed and inventory investment, taken together, have risen only moderately. Indeed, internal corporate funds exceeded investment over the course of last year for the first time since 1975.

Similar cautious behavior has also been evident in the hiring decisions of U.S. firms, during the past several years. Rather than seeking profit opportunities in expanding markets, business managers hunkered down and focused on repairing severely depleted profitability predominately by cutting costs and restricting their hiring. Firms succeeded in that endeavor largely by taking advantage of the untapped potential for increased efficiencies that had built up during the rapid capital accumulation of the latter part of the 1990s. That process has not yet played out completely. Many firms seem to be continuing to find new ways to exploit the technological opportunities embodied in the substantial investments in high-tech equipment that they had made over the past decade.

When aggregate demand accelerated in the second half of 2003, the pace of job cuts slowed. But because of the newfound improvements in the efficiency of their operations, firms were able to meet increasing demand without adding many new workers.

As the opportunities to enhance efficiency from the capital investments of the late 1990s inevitably become scarcer, productivity growth will doubtless slow from its recent phenomenal pace. And, if demand continues to firm, companies will ultimately find that they have no choice but to increase their workforces if they are to address growing backlogs of orders. In such an environment, the pace of hiring should pick up on a more sustained basis, bringing with it larger persistent increases in net employment than those prevailing until recently.

Still, the anxiety that many in our workforce feel will not subside quickly. In March of this year, about 85,000 jobless individuals per week exhausted their unemployment insurance benefits—more than double the 35,000 per week in September 2000. Moreover, the average duration of unemployment increased from twelve weeks in September 2000 to twenty weeks in March of this year. These developments have led to a notable rise in insecurity among workers.

Most of the recent increases in productivity have been reflected in a sharp rise in the pretax profits of nonfinancial corporations from a very low 7 percent share of that sector's gross value added in the third quarter of 2001 to a high 12 percent share in the fourth quarter of last year. The increase in real hourly compensation was quite modest over that period. The consequence was a marked fall in the ratio of employee compensation to gross nonfinancial corporate income to a very low level by the standards of the past three decades.

If history is any guide, competitive pressures, at some point, will shift in favor of real hourly compensation at the expense of corporate profits. That shift, coupled

with further gains in employment, should cause labor's share of income to begin to rise toward historical norms.

Such a process need not add to inflation pressures. Although labor costs, which compose nearly two-thirds of consolidated costs, no longer seem to be falling at the pace that prevailed in the second half of last year, those costs have yet to post a decisive upturn. And even if they do, the current high level of profit margins suggests that firms may come under competitive pressure to absorb some acceleration of labor costs. Should such an acceleration of costs persist, however, higher price inflation would inevitably follow.

The pace of economic expansion here and abroad is evidently contributing to some price pressures at earlier stages of the production process and in energy markets, and the decline in the dollar's exchange rate has fostered a modest firming of core import prices. More broadly, however, although the recent data suggest that the worrisome trend of disinflation presumably has come to an end, still-significant productivity growth and a sizable margin of underutilized resources, to date, have checked any sustained acceleration of the general price level and should continue to do so for a time. Moreover, the initial effect of a slowing of productivity growth is more likely to be an easing of profit margins than an acceleration of prices.

As I have noted previously, the federal funds rate must rise at some point to prevent pressures on price inflation from eventually emerging. As yet, the protracted period of monetary accommodation has not fostered an environment in which broad-based inflation pressures appear to be building. But the Federal Reserve recognizes that sustained prosperity requires the maintenance of price stability and will act, as necessary, to ensure that outcome.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 14, 2004

The Honorable Paul S. Sarbanes
United States Senate
Washington, D.C. 20510

Dear Senator:

As promised, I am responding to your inquiry during my recent testimony before the Joint Economic Committee about the pace and cumulative magnitude of policy adjustments in past episodes in which the Federal Open Market Committee raised the target federal funds rate substantially.

As noted in the enclosed table, there have been three such episodes in the past seventeen years. Over a period of about thirteen months extending from March 1988 through May 1989, the target federal funds rate increased 3.31 percentage points. In the twelve months from February 1994 through February 1995, the target rate rose 3.00 percentage points. Lastly, in the ten months or so from late June 1999 to May 2000, the target rate was boosted 1.75 percentage points.

As I noted in my testimony, the current highly accommodative stance of monetary policy must be returned to a more neutral setting at some point in order to foster price stability and maximum sustainable economic growth. However, judging the likely pace and duration of that transition solely on the basis of past episodes is not appropriate. As the FOMC indicated in its May 4th statement, the current backdrop of low inflation and underutilized resources suggests that the transition to a more neutral policy stance can be undertaken at a pace that is likely to be measured.

I hope these comments are helpful. Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Duration and Cumulative Increases in the Target Funds Rate in Past Episodes of Monetary Policy Firming

	Target Rate At Beginning of Episode (1)	Target Rate At End of Episode (2)	Cumulative Increase in Target Rate (3) = (2) - (1)	Length of Period of Policy Adjustment (months) (4)
March 1988 to May 1989	6.50	9.81	3.31	13
February 1994 to February 1995	3.00	6.00	3.00	12
June 1999 to May 2000	4.75	6.50	1.75	10+

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 18, 2004

The Honorable Susan M. Collins
United States Senate
Washington, D.C. 20510

Dear Senator:

During my appearance before the Joint Economic Committee on April 21, you asked my views on possible public policies to deal with the loss of jobs associated with the long-run decline in the demand for labor in the manufacturing sector. In my view, the issue has two aspects: transitional income support while workers are unemployed, and training to acquire the skills needed for a new job.

In considering this issue, it is important to remember that over the long sweep of American generations and waves of economic change, we have not experienced a net drain of jobs to advancing technology or to other nations. Since the end of World War II, for example, the unemployment rate in the United States has averaged less than 6 percent with no apparent trend; and as recently as 2000, it dipped below 4 percent. We can thus be confident that new jobs will replace lost ones as they always have. Unfortunately, this process of "creative destruction" does not occur without a high degree of pain for those caught in the job-losing segment of America's massive job-turnover process. Transitional income support and training programs are the public policy tools most suited for dealing with that pain.

With regard to transitional income support, I believe that our unemployment insurance system has evolved in a way that seems close to optimal. On the one hand, the system does not encourage undue unemployment by creating excess benefits that encourage benefit recipients not to seek employment, while on the other hand, the replacement rate on previous earnings is not punitive.

We have extended, of course, unemployment insurance on previous occasions when it was fairly clear that the number of individuals unemployed through no fault of their own was quite large. My view is that under current circumstances, with the rate of exhaustions quite high, the Temporary Extended Unemployment Compensation Program should be re-authorized for a short period of time to eligible unemployed workers.

The Honorable Susan M. Collins
Page Two

Another program currently in place for providing transitional income support is trade adjustment assistance. Clearly, we ought to assist those who, through no fault of their own, are in industries that are under significant international competitive pressure. But it is difficult, if not impossible, to differentiate in any meaningful sense whether a permanent job loss was ultimately caused by productivity, imports, outsourcing or some other factor. Accordingly, I think policy should be directed largely, so far as income support is concerned, through the unemployment insurance system.

Training is the other area where public policy can assist workers who have been adversely affected by longer-run structural change in the economy. With the ever-increasing pace of economic change, the old notion of getting out of high school or even college and having a job for the rest of your life is no longer a realistic expectation. In today's world, education has to be viewed as a process of lifetime learning. As a consequence, the nature of education is of necessity changing. As I have often noted, community colleges, which largely tend to be focused on providing the education and training needed to move from one occupation to another, play an important role in this process. Reflecting these developments, community colleges have undergone explosive growth in recent years.

Our current trade assistance programs also have a training aspect. As with the income support aspect of trade assistance, I think the training aspects also should be integrated into the more general system of training support for unemployed workers. In my opinion, making training as a consequence of imports different from training for workers who lose jobs because of increased technology or other reasons is an awkward public policy structure.

More generally, public policy should recognize that a job loss is a job loss, regardless of why it occurred. Accordingly, the Congress should consider further coordinating or consolidating the more than thirty training programs that currently are spread across nine departments and agencies.

I hope these thoughts are helpful.

Sincerely,

Alan Greenspan

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

May 14, 2004

The Honorable Jennifer B. Dunn
House of Representatives
Washington, D.C. 20515

Dear Congresswoman:

I am pleased to enclose my responses to the questions you forwarded to me in connection with the Joint Economic Committee hearing of April 21. A copy has also been forwarded to the Committee for inclusion in the hearing record.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Chairman Greenspan subsequently submitted the following in response to written questions received from Congresswoman Jennifer Dunn in connection with the April 21, 2004, hearing before the Joint Economic Committee:

1. In reply to a question by Rep. Saxton, speaking of the process whereby the FOMC evaluates and reaches determinations on interest rates, you stated ". . . we are still developing the means by which we formulate policy. And it's becoming more programmatic in the sense that it thinks in terms of strategies, rather than individual, period-by-period developments."

- **a. Does this programmatic, strategic methodology take into account regional variations in economic conditions? For instance, economic growth and job production have lagged in my own region of the Pacific Northwest. Does the "program" you speak of allow for regional variations or does it take into account the impact of higher interest rates on regions where economic growth lags behind the rest of the nation?**
- **b. Should such a program take into account regional variations in order to avoid the potentially harmful effect of high interest rates on economies that are struggling to revive?**

In formulating monetary policy, the Federal Reserve is well aware of regional variations in economic conditions. Indeed, one of the advantages of the federal structure of the Federal Reserve System is that a large volume of anecdotal information on regional economic performance is gathered by the twelve Federal Reserve Banks. This sort of information is reported to policymakers through the so-called Beige Book, a summary of regional economic conditions that is prepared for each FOMC meeting on a rotating basis by one of the Reserve Banks. In addition, the twelve Reserve Bank presidents discuss conditions in their districts, as well as in the national economy, at each FOMC meeting. Nonetheless, the Federal Reserve must make monetary policy in view of overall economic conditions and for the benefit of the nation as a whole. The Federal Reserve Act clearly calls for the Federal Reserve to promote our national goals of full employment and price stability. And, in any case, the United States has a single money and capital market, and the Federal Reserve effectively has only a single policy tool--its ability to influence short-term interest rates in the national money market. Thus, the Federal Reserve has no

capability to pursue differential monetary policies aimed at separately influencing economic conditions in the various regions.

2. In reply to a question by Rep. Stark on the extension of unemployment compensation, you mention that "our unemployment insurance system has been crafted and has evolved in the way which seems to me as close to optimum as you can make such a system....my view is that if we make the extension short, because it's not going to be required very long, I do think it's a good idea."

- **a. Would you favor extending unemployment insurance and linking its termination to an economic indicator (e.g., job growth)?**
- **b. What would be an appropriate length of extension or what factor should be used in ending such an extension?**

As I indicated at the hearing, during the recent period of extended weakness in the labor market, extended unemployment insurance benefits have been providing necessary income support to jobless workers who have exhausted their regular program benefits. With hiring now having shown signs of improvement, any extension of unemployment insurance benefits should be appropriately short. If the Congress chooses to extend benefits now for a time, it should, in advance of the program's expiration, reexamine the need for extended unemployment insurance benefits, reassessing whether such a policy is desirable in light of the prevailing economic conditions.

I am, however, wary of linking the termination of those benefits, or alternatively the triggering of extended benefits, to any economic indicator. The labor market conditions that warrant the provision of extended unemployment benefits are difficult to summarize with any single economic indicator or predetermined set of indicators. From month to month, our statistics on employment can provide different signals, and they are subject to revision. Beyond these statistical considerations is the need for the Congress to undertake a broader assessment of whether those workers exhausting unemployment insurance are likely to be reabsorbed in new jobs as they are created. Such an assessment might be based, among other things, on the available information on trends in employment, on unemployment and its distribution by duration, on new accessions and layoffs, and on exhaustions.